

EVERCORE ISI

Energy | Power & Utilities

August 07, 2020

Essential Utilities Inc.

WTRG | \$45.56

In Line | TARGET PRICE: \$42.00 (from \$38.00)

Earnings Report

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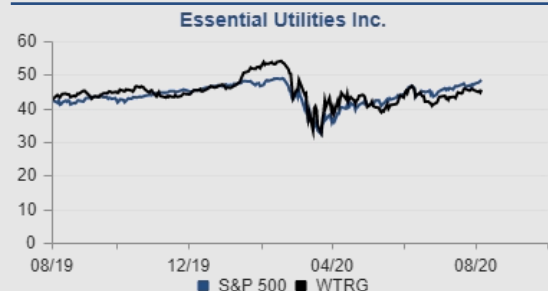
Company Statistics

Market Capitalization (M)	\$8,597
Shares Outstanding (M)	223
Dividend	1.03
Dividend Yield	2.7%
Payout Ratio	66.1%
Expected Total Return	11.8%
Fiscal Year End	Dec

Earnings Summary

	2020E	2021E	2022E
EPS	\$1.55	\$1.65	\$1.80
P/E	24.8	23.3	21.3
EPS vs Consensus	(0.8)%	0.2%	1.9%
Consensus EPS	\$1.57	\$1.65	\$1.77
Consensus P/E	24.6	23.3	21.8

1 Year Price History



Solid Quarter, LT Outlook Reaffirmed

Essential posted a solid beat in the second quarter reporting EPS of \$0.29 versus consensus of \$0.23. Helped in part by favorable weather, residential load more the offset decline in Commercial/Industrial usage resulting in no meaningful COVID impact during the quarter. The company filed for repair tax catch-up with the PA Commission (~\$0.05 annual EPS uplift if approved our estimate) and advanced Delcora transaction process expected to close early next year. They still expect to issue \$300MM in equity later this year to finance the deal (\$0.03 EPS contribution included in our forecast). WTRG also reaffirmed its 2020 EPS guidance range of \$1.53-\$1.58 and still projects EPS to grow in the range of 5-7% on average from 2019 through 2022.

Target Price \$42, rating In Line. Our \$42 target price is based on a SOTP where we now assign 26.5x P/E to the '22 earnings contribution from the legacy water business and ~ 16.5x to earnings from the gas segment. The 26.5x water P/E is a ~15% premium to our water utility average target multiple of 23x which we think is warranted in this environment given above average residential customer mix which positions them well against COVID related demand headwinds. Majority of their water EPS is derived from PA which is also a relative advantage versus peers. The gas multiple of ~16.5x is also in line with current gas LDC. We see bull/bear case valuation of \$48/\$38 respectively, and given the potential upside opportunity from tax catch up, municipal water/waste water deals and other complementary growth projects we assign low probability to our bear case scenario, see page 2 of the report.

Repairs Tax Election Uplift, 8-12c/yr. Essential's 2020 and forward looking EPS guidance includes 8-12c/share annual earnings uplift which is more/less in line with our estimate of ~10c. There may be additional accretion from historical balances pending commission review and final decision. For context, in 2012, Aqua (water utility) changed its tax method of accounting for qualifying utility asset repairs in PA. The tax accounting method was changed to permit the expensing of certain utility asset repairs/maintenance costs that were previously being capitalized and depreciated for tax purposes. The company used flow-through accounting for the tax benefits of the repair tax accounting change per the Pennsylvania rate order from June '12. The flow-through accounting implementation resulted in a reduction in the company's effective income tax rate, which in turn lowered income tax expense and increased net income. WTR's effective tax rate was materially lower than the statutory tax rate at (7.7%) / 6.6% / 8.2% for the years '18 / '17 / '16 respectively. Higher earnings power supported higher returns on equity, which allowed Aqua to invest over \$2bn of capital on system improvements over the past seven years without having to go in for rate cases in PA. There could be further earnings upside (~\$0.05 annual EPS uplift by our estimate) if the commission allows favorable treatment of the legacy tax balance.

DELCORA opportunity. In September '19, management had announced a signed purchase agreement with Delaware County Regional Water Authority (DELCORA), following the latter's signing of a letter of intent with Aqua committing to exclusive discussions in August '19. DELCORA is a wastewater conveyance and treatment authority that serves approximately 500,000 people in 42 municipalities in Delaware and Chester Counties in southeastern Pennsylvania. We estimate that this could be a potential ~\$300mm rate base / \$0.03 EPS uplift in '21 (included in our forecast), assuming 50%/50% debt/equity financing.

We are changing our PT to \$42 for WTR; our rating remains In Line. Our \$42 target price is based on a SOTP where we now assign 26.5x P/E to the '22 earnings contribution from the legacy water business and ~ 16.5x to earnings from the gas segment. The 26.5x water P/E is a ~15% premium to our water utility average target multiple of 23x which we think is warranted in this environment given above average residential customer mix which positions them well against COVID related demand headwinds. Majority of their water EPS is derived from PA which is also a relative advantage versus peers. The gas multiple of ~16.5x is also in line with current gas LDC. Our bull case valuation of \$48 assumes that they are able to achieve ~\$0.05 combined upside from tax repairs, and both the water and gas segment trade at 10% premium to our base case scenario. Our bear case valuation of \$38 assumes a 5% discount multiple to our base case scenario for both segments and low end of targeted LT EPS growth. Please see Exhibit 1 for additional details.

Exhibit 1

WTR Valuation Framework

SOTP Valuation (Base Case)	'22E	'21 P/E	Valuation
Legacy WTR EPS	\$1.26	26.4x	\$33.00
Gas EPS	\$0.54	16.5x	\$9.00
	<u>\$1.80</u>		<u>\$42.00</u>
SOTP Valuation (Bull Case)	'21E	'21 P/E	Valuation
Legacy WTR EPS	\$1.29	29.0x	\$38.00
Gas EPS	\$0.55	18.1x	\$10.00
	<u>\$1.85</u>		<u>\$48.00</u>
SOTP Valuation (Bear Case)	'21E	'21 P/E	Valuation
Legacy WTR EPS	\$1.19	25.1x	\$30.00
Gas EPS	\$0.51	15.7x	\$8.00
	<u>\$1.70</u>		<u>\$38.00</u>

Source: Evercore ISI Research

VALUATION METHODOLOGY

Our \$42 target price is based on a SOTP where we now assign 26.5x P/E to the '22 earnings contribution from the legacy water business and ~ 16.5x to earnings from the gas segment. The 26.5x water P/E is a ~15% premium to our water utility average target multiple of 23x which we think is warranted in this environment given above average residential customer mix which positions them well against COVID related demand headwinds.

RISKS

Risks to our thesis include an unfavorable regulatory outcome leading to lower rate base growth and/or lower allowed or earned ROEs in ongoing and future rate cases. Other risks include exposure to unusual weather, impact of conservation awareness of customers and more efficient plumbing fixtures and appliances on water usage per customer, cyber security and water contamination.

COMPANIES UNDER COVERAGE BY AUTHOR

Symbol	Company	Rating	Price (2020-07-08)	Evercore ISI Target
AEE	Ameren Corp.	Outperform	\$81.06	\$84.00
AEP	American Electric Power	Outperform	\$85.37	\$95.00
AES	The AES Corporation	Outperform	\$16.55	\$20.00
AGR	Avangrid Inc	In Line	\$48.39	\$46.00
AWK	American Water Works Company, Inc.	Outperform	\$146.97	\$129.00
AWR	American States Water Company	Underperform	\$76.65	\$60.00
CMS	CMS Energy Corp.	In Line	\$61.75	\$63.00
CNP	CenterPoint Energy, Inc.	In Line	\$20.27	\$18.00
CWEN	Clearway Energy	In Line	\$25.77	\$22.00
CWT	California Water Service Group	In Line	\$46.96	\$40.00
D	Dominion Energy, Inc	In Line	\$79.63	\$77.00
DTE	DTE Energy Co.	In Line	\$116.94	\$120.00
DUK	Duke Energy Corp.	In Line	\$84.21	\$87.00
ED	Consolidated Edison Inc.	In Line	\$73.92	\$85.00
EIX	Edison International	In Line	\$53.87	\$72.00
ES	Eversource Energy	In Line	\$88.10	\$91.00
ETR	Entergy Corp.	In Line	\$102.29	\$106.00
EVRG	Evergy	Outperform	\$54.75	\$62.00
EXC	Exelon Corp.	Outperform	\$37.90	\$45.00
FCFE18-MX	CFE Capital S. de R.L. de C.V.	Outperform	MXN25.28	MXN19.00
FE	FirstEnergy Corp.	In Line	\$29.18	\$41.00
HE	Hawaiian Electric Industries Inc.	Underperform	\$35.04	\$34.00
NEE	NextEra Energy Inc	In Line	\$282.81	\$277.00
NI	NiSource Inc	Outperform	\$24.34	\$26.00
NRG	NRG Energy Inc.	Outperform	\$33.98	\$40.00
OGE	OGE Energy Corp	Outperform	\$32.94	\$35.00
PCG	PG&E Corp.	Rating Suspended	\$9.10	
PEG	Public Service Enterprise Group	In Line	\$54.63	\$53.00
PNM	PNM Resources, Inc	In Line	\$42.84	\$44.00
PNW	Pinnacle West Capital Corp.	In Line	\$80.79	\$85.00
PPL	PPL Corp.	In Line	\$26.50	\$31.00
SJW	SJW Group	In Line	\$64.76	\$60.00
SO	Southern Co.	In Line	\$53.89	\$59.00
SRE	Sempra Energy	Outperform	\$128.20	\$138.00
VST	Vistra Energy Corp	Outperform	\$18.83	\$27.00
WEC	WEC Energy Group, Inc.	In Line	\$92.99	\$93.00
WTRG	Essential Utilities Inc.	In Line	\$45.56	\$42.00
XEL	Xcel Energy Inc.	In Line	\$70.10	\$65.00

TIMESTAMP

(Article 3(1)e and Article 7 of MAR)

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Outperform- the total forecasted return is expected to be greater than the expected total return of the analyst's coverage universe

In Line- the total forecasted return is expected to be in line with the expected total return of the analyst's universe

Underperform- the total forecasted return is expected to be less than the expected total return of the analyst's universe

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*Prior to October 10, 2015, the "Coverage Suspended" and "Rating Suspended" categories were included in the category "Suspended."

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Prior to March 2, 2017, Evercore ISI's recommendations were based on a stock's total forecasted return over the next 12 months:

Buy- the total forecasted return is expected to be greater than 10%

Hold- the total forecasted return is expected to be greater than or equal to 0% and less than or equal to 10%

Sell- the total forecasted return is expected to be less than 0%

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Strong Buy- Return > 20%

Buy- Return 10% to 20%

Neutral - Return 0% to 10%

Cautious- Return -10% to 0%

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Overweight- the stock is expected to outperform the average total return of the analyst's coverage universe over the next 12 months.

Equal-Weight- the stock is expected to perform in line with the average total return of the analyst's coverage universe over the next 12 months.

Underweight- the stock is expected to underperform the average total return of the analyst's coverage universe over the next 12 months.

Suspended- the company rating, target price and earnings estimates have been temporarily suspended.

For disclosure purposes, Evercore Group's prior "Overweight," "Equal-Weight" and "Underweight" ratings were viewed as "Buy," "Hold" and "Sell," respectively.

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Short- the stock is a negative holding in the model portfolio; the total forecasted return is expected to be less than 0%.

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Stocks included in the model portfolio will be weighted from 0 to 100% for Long and 0 to -100% for Short. A stock's weight in the portfolio reflects the analyst's degree of conviction in the stock's rating relative to other stocks in the portfolio. The model portfolio may also include a cash component. At any given time the aggregate weight of the stocks included in the portfolio and the cash component must equal 100%.

Stocks assigned ratings under the alternative model portfolio-based coverage system cannot also be rated by Evercore ISI's Current Ratings definitions of Outperform, In Line and Underperform.

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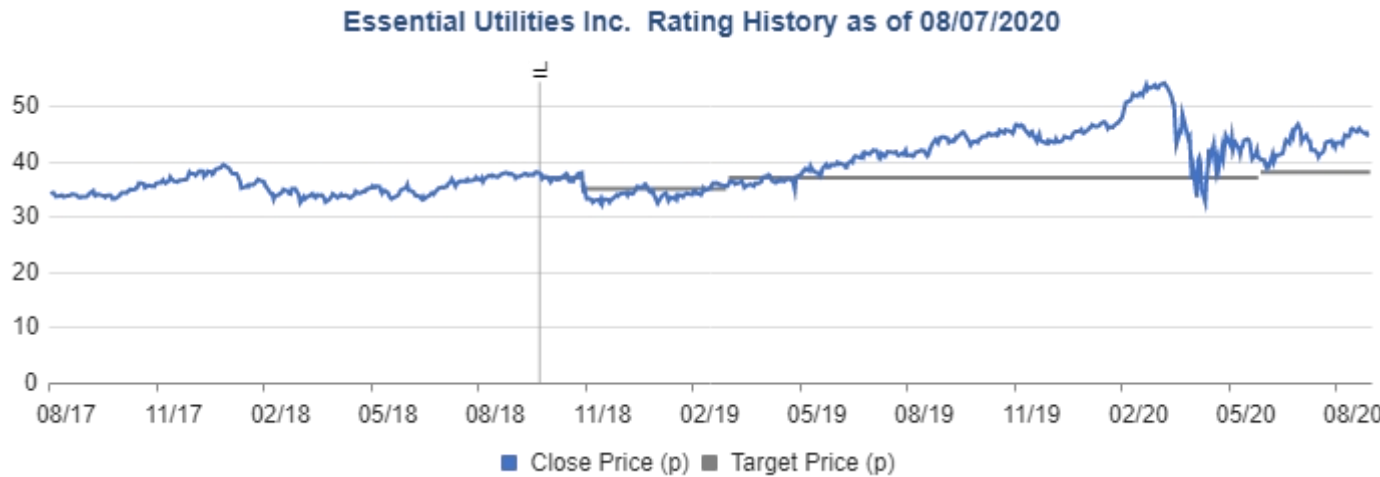
Evercore ISI rating (as of 08/07/2020)

Coverage Universe			Investment Banking Services I Past 12 Months		
Ratings	Count	Pct.	Ratings	Count	Pct.
Buy	377	49	Buy	110	29
Hold	307	40	Hold	49	16
Sell	46	6	Sell	4	9
Coverage Suspended	21	3	Coverage Suspended	6	29
Rating Suspended	15	2	Rating Suspended	3	20

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Price Charts



Ratings Key

B	Buy	OP	Outperform	L	Long	CS	Coverage Suspended
H	Hold	IL	In Line	NP	No Position	RS	Rating Suspended
S	Sell	UP	Underperform	S	Short		

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